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INFORMATION SOURCES FOR AGRICULTURAL LENDERS

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Introduction:

Self-sufficiency was a main feature of agricultural production before mechanization in the 1920's. There was little need for outside funds. Most production inputs were produced on the farm. The unsophisticated equipment of that era was relatively inexpensive and was usually purchased on a cash basis. Land mortgages represented about the only debts owed by farmers.

Farming and farmers' use of credit has changed drastically in the last 50 years. The trend toward fewer, larger, more specialized farms requiring larger and larger amounts of capital has continued. In 1980, farmers as a group borrowed about $150 billion. By 1985, it has been estimated that aggregate farm debt will exceed $250 billion or approximately $100,000 per farm.[1]

The wise use of credit can help a farm business grow by allowing the owner or owners to purchase additional land, labor replacing capital equipment, and additional production inputs. These purchased assets add to the productive capacity of the farm immediately. If operations are profitable, earnings will also increase, some of which can then be used to pay principle and interest on the debt incurred. The use of credit can help a farm business achieve economies of size in order to improve the firm's cost structure or to gain marketing efficiencies. Borrowed capital can help smooth seasonal disparities in income and expenditures, aiding cash flow management. Maintaining a credit reserve helps some agricultural producers deal with the business risks inherent in agricultural production. Other producers use reserve credit to take advantage of investment opportunities that arise from time to time.

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[1]Warren F. Lee, et al. Agricultural Finance, seventh edition. (Ames, IA: The Iowa State University Press, 1980).

The increasing use of credit by agricultural producers has placed agricultural lenders in a dilemma. On the one hand, agricultural lenders find themselves making time-consuming decisions that are taking on a growing importance because of the sheer size and the risk factors involved. On the other hand, lenders find it necessary to spend more time keeping themselves informed about specialized crop and livestock enterprises in a rapidly changing technological environment. Also, while many farmers keep excellent financial records, lenders spend large amounts of time constructing financial statements for some farmer customers.

The crux of the problem is information. Agriculture lenders need up-to-date information in order to perform agricultural loan analyses. The amount and type of information needed by an individual lender depends, to a large extent, on that lender's level of experience. An experienced lender often is familiar with various information sources and maintains current files. Still, the experienced lender needs to keep himself informed about technological developments in agriculture. An inexperienced lender or a lender not having a background in agriculture faces a difficult situation. This person may not be aware of the wide variety and large amount of information available. Of greater concern, this lender may not even be sure of the information needed for the loan analysis. An experienced lender often is familiar with various information sources. Still, the experienced lender needs to keep informed about technological developments in agriculture and should always be looking for new and better information sources.

The purpose of this paper is twofold: 1) to discuss the basic financial and agronomic considerations in making loan decisions. 2) To provide a list of information sources available to agricultural lenders. A discussion of the basic considerations in making agricultural credit analyses may help identify

information needs. The next step is to locate information sources. The list of references provided will help lenders become aware of publications of which they are not now making use.

Methods of analysis will be discussed briefly as information needs are pointed out. To facilitate the discussion of information needs involved in an agricultural loan decision, a hypothetical case study will be used. A listing of information sources will follow the case analysis. Each publication will be described briefly. Directions for obtaining the publications will also be given.

Loan Analysis:

All lenders, agricultural lenders included, must serve in two capacities when conducting lending operations. One role is that of a manager of funds, the goal of which is to achieve as high a return as possible without taking undue risk. The second role involves serving as trustee of depositor's funds. In making loans, an agricultural lender must attempt to achieve the goals of these two objectives while maintaining the well-being of borrowers.

While loan analysis procedures differ, all lenders must consider three things, primarily from the standpoint of the borrower, when analyzing a loan application. (1) profitability, (2) liquidity, and (3) solvency.

Profit simply means revenues for a particular investment are greater than the costs involved. This must be true for both lender and borrower. In his role as a manager of funds, a lender must determine the profitability of a particular loan for the lending institution he represents.

To determine the profitability of a borrower's investment supported by a loan, the lender must rely on information supplied by the borrower and his own experience and judgement. A lender can get a good idea of a borrower's ability to manage a farm business profitably by examining historical income

statements. A stable, growing net income would give a lender reason to believe a borrower could continue to manage successfully.

For expanded enterprises or new enterprises, the lender will want to project revenues and costs to estimate profitability. In order to help prepare or to judge such projections, the agricultural lender must have a good base of technical agronomic knowledge. This knowledge base must be kept up to date. Some of the more important agronomic factors include:

(a) Land Use: The chemical and topographical features of soils under certain climatic conditions are the determinants of the "best use" of land. Knowledge of the best use of land may help lenders discuss with the farmer the profit maximization potential of various cropping programs.

(b) Soil and Water Conservation: A crop production forecast must be based on cropping practices as well as the growing environment which includes soil and water conservation efforts. Correct fertilization programs, proper use of crop rotation and careful use of pesticides, all ensure that nutrients and moisture are used to best advantage.

(c) Technology: Farmers, as a group, have become accustomed to the fast advancement of technology. Lenders must keep current since they advise borrowers on the feasibility of adoption.

(d) Care of Crops: A lender can be more sure of profit projections if borrowers practice good crop management techniques, both before and after harvesting. These include seed selection, fertilization, pesticide program, cultivation, harvesting, storage, and transportation to market. Awareness of proper practices would enable a lender to judge the practices used by a particular borrower.

(e) Care of Livestock: In general terms, the comments made for crops also apply to livestock. The lender must understand livestock production

practices sufficiently to make sure a borrower is managing his livestock enterprises in the most profitable manner.

Liquidity is the ability to meet financial obligations as they come due without disrupting business operations. An up-to-date balance sheet provides the best indication of a borrower's current liquidity situation. However, a complicating factor from a lender's point of view is the strong balance sheet position of many farmers because of rapidly increasing land values. It has become common because of the business risks inherent in agricultural production for some farmers to experience difficulties with liquidity, in other words a cash flow problem, even though their asset base is large and growing.

Analysis of liquidity is an important part of an agricultural lender's job because of business risk. Business risk is commonly defined as the variation in net income due to the risk and uncertainty inherent in a particular business operation. There is a great deal of business risk involved in farming because of the biological nature of the agricultural production process.

Different types of business risk and uncertainty of which an agricultural lender must be aware include:

1) Production Uncertainty: Weather is the variable which has the largest impact on production. But pests and disease, in the case of livestock, can also alter output drastically. A lender may suggest strategies that would help a borrower reduce production uncertainties.

One strategy is diversification built upon flexibility among enterprises. By keeping fixed costs as low as possible, a farmer has the option of switching enterprises when necessary. By having more than one enterprise, an agricultural producer can reduce production uncertainty. This strategy is based on the assumption that it would be unlikely for all enterprises to be adversely affected at the same time.

Another strategy for dealing with production uncertainty is to maintain a financial cushion. Although some farmers are in a position to provide their own financial reserve, most are not. A lender can help by providing a reserve of borrowing capacity.

2) Price Uncertainty: For most agricultural products, prices are determined by the interaction of market forces modified by government programs. An unexpected price change can drastically alter a borrower's income situation. A lender must be aware of agricultural price trends.

A tool lenders and borrowers have increasingly used in recent years to mitigate price uncertainty is forward contracting. Both cash forward contracts and futures forward contracts have been used to lock in the cost of inputs and prices of farm products sold. While price uncertainty can't be entirely eliminated, forward contracting can reduce the danger of adverse price movements significantly.

3) Technological Uncertainty: A reduction of net income may occur either because a borrower does adopt technology or because he does not. Adoption of new technology, if it works, will increase revenues or decrease per unit costs which will increase net income. Under these circumstances, a non-adopter will find himself less able to compete. If the new technology doesn't work as predicted, the adopter will be saddled with higher costs with less revenue than expected. A lender is in a position to help guide technology adoption decisions. It is essential the lender keep himself well informed about relevant technological advances.

4) Casualty Risks: Casualty losses can be caused by fire, flood, wind, hail, theft, vandalism, and a number of other forces. The lender may recommend that a borrower purchase insurance to reduce the potential impact of certain events.